ORIGINAL

Before the
FEDERAL COMMUNICATIONS COMMISSION
Washington, D.C. 20554

In the Matter of	)	
	)	
Application of BellSouth Corporation,	)	CC Docket No. 97-208
BellSouth Telecommunications, Inc.	)	
and BellSouth Long Distance, Inc.	)	
for Provision of In-Region, InterLATA	)	
Services in South Carolina	)	

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Exhibit E:
Declaration of Kenneth C. Baseman and Frederick R. Warren-Boulton
on Behalf of MCI Telecommunications Corporation

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DECLARATION OF
KENNETH C. BASEMAN AND FREDERICK R. WARREN-BOULTON
ON BEHALF OF MCI

I. INTRODUCTION

1. Frederick R. Warren-Boulton is a Principal with MiCRA (Microeconomic Consulting and Research Associates, Inc.), a Washington-based economics consulting and research firm specializing in antitrust and regulatory matters. He holds a B.A. degree from Yale University, a Master of Public Affairs from the Woodrow Wilson School of Public and International Affairs at Princeton University, and M.A. and Ph.D. degrees in Economics from Princeton University. From 1972 to 1983, he was an Assistant and then Associate Professor of Economics at Washington University in St. Louis.

2. From 1983 to 1989, Dr. Warren-Boulton served as the chief economist for the Antitrust Division of the U.S. Department of Justice, first as the Director of its Economic Policy Office and then as the Deputy Assistant Attorney General for Economic Analysis. Since leaving the Department of Justice, he has served as a Resident Scholar at the American Enterprise Institute, a Visiting Lecturer of Public and International Affairs at the Woodrow Wilson School at Princeton University, and a Research Associate Professor of Psychology at The American University.

3. Dr. Warren-Boulton's area of specialization is in the economics of industrial organization. His publications are primarily in the application of industrial organization economics to antitrust and regulation, including a number of papers that consider appropriate

public policy toward regulated industries, including telecommunications. A complete description of his background and papers can be found in his Curriculum Vitae, a copy of which is attached to this Declaration.

4. Kenneth Baseman is a Principal with MiCRA, an economic consulting firm in Washington, D.C. He received his graduate training in economics at Stanford University. He served as a senior economist in the Economic Policy Office of the Antitrust Division of the Department of Justice where, for over two years, he was a member of the Division's trial staff in U.S. v. AT&T. He has been an economic consultant for thirteen years. His consulting assignments have focused primarily on competitive issues, both in antitrust and regulatory proceedings. His earlier professional papers dealt with entry and competition in a regulated industry with natural monopoly characteristics and were published in the *American Economic Review,* and by the National Bureau of Economic Research and the MIT Press. His more recent publications have focused on the use of non-linear pricing and technical incompatibility by dominant firms to preserve market power in the face of developing competition. He has consulted on telecommunications issues with the Department of Justice, MCI, AT&T, the National Cable Television Association, and WebCel Communications. A copy of his vita is attached to this Declaration.

5. MCI has asked us to analyze the provision of interLATA service in South Carolina by BellSouth. We conclude that the provision of in-region, interLATA service by BellSouth is

premature and should not be allowed now. BellSouth's provision of interLATA service in its own territory must be linked to the level of competition in local telephone markets. BellSouth's control over bottleneck local facilities gives it the incentive and the ability to harm competition in the long-distance market and to stifle nascent competition in the local markets. Regulation will be insufficient to control such incentives and monopoly power. Consequently, only widespread, effective facilities-based local competition will prevent BellSouth from acting on its ability and incentive to harm the competitive process.

6. Any complete analysis of an RBOC's entry application must address both the benefits and the costs of such entry. Our Declaration focuses on the costs; i.e., the potential harm to competition and economic efficiency associated with BellSouth's application. In a companion Declaration, Robert Hall addresses and rebuts arguments frequently made by RBOCs, including those advanced by BellSouth's economists in this proceeding, that the long-distance industry is performing poorly and RBOC entry is needed to break up a tacitly collusive long-distance cartel. We agree with Professor Hall that significant economies of vertical integration from RBOC entry into interLATA service are very unlikely, especially given the requirements for structural separation in Section 272 of the 1996 Act. Absent any credible expected benefits from interLATA entry by the RBOCs, the FCC's entry decision should turn on whether the expected costs of interLATA entry by the RBOCs are also negligible. We find that these risks are quite substantial at this time, however, so that BellSouth should not now be allowed to offer interLATA service in South Carolina.

II. THERE ARE SIGNIFICANT SOCIAL COSTS FROM PREMATURELY ALLOWING AN RBOC TO PROVIDE INTERLATA SERVICE.

A. The linkage between allowing an RBOC to offer interLATA service and the level of competition in local telephone markets.

7. There are three distinct rationales for linking an RBOC's entry into interLATA service to the level of competition for local services. First, as long as the RBOC controls a regulated, bottleneck facility, it will have powerful incentives for anticompetitive behavior if it is allowed to participate in other markets for which access to the bottleneck is essential. This is true in particular for the long-distance market. When customers have a real choice among facilities-based local competitors, independent long-distance companies will become less dependent on the RBOC's upstream (i.e., local exchange) services, reducing the incentive for anticompetitive behavior by the RBOC and reducing the potential harm to competition in downstream markets.

8. Second, premature entry into interLATA long distance will allow the RBOC to engage in behavior that will limit the extent to which local competition can develop. Among these strategies are signing up customers for bundled local and long-distance services before local competition has had a chance to develop; the use of customer specific discounts on long-distance or bundled services in order to cut prices to local service customers most likely to patronize new local service entrants; raising the cost to customers of switching local service providers; and providing poor service when customers switch to new local carriers (thereby damaging the new

carrier's reputation and requiring it to incur additional costs to mollify their customers). These strategies can all enable the RBOC to "lock in" its control over local service customers prior to the development of effective local competition.

9. Third, regulatory approval of interLATA entry serves as a reward or "carrot" to induce the RBOCs to open up their local networks. Under the 1996 Act, they are required to unbundle their local networks and sell the components at cost-based rates. But these actions on the part of the RBOC, while legally required, are complex and difficult to monitor. It will be hard for regulators to determine if the RBOC is really complying with the Act's requirements to the best of its ability. If an RBOC receives the carrot of long-distance entry before it has opened its network in a meaningful and irreversible way, its sole business incentive to cooperate in setting reasonable terms, conditions, and operating procedures for local network access by competing local exchange carriers is eliminated.

B. An RBOC would have powerful anticompetitive incentives in the in-region, interLATA business if it were allowed to enter.

10. An RBOC's entry into in-region, interLATA long-distance service is likely to harm the competitive process and therefore make consumers of long-distance and local services worse off, unless it faces effective competition in the markets for unbundled network elements and for retail local exchange services. Until effective local competition develops at both levels, the RBOC

will continue to control bottleneck upstream facilities. Economists and policy-makers have long recognized the dangers of allowing a regulated, bottleneck monopolist to compete in related markets. Absent either enough facilities-based local entry, so that competition replaces regulation as the effective constraint in the RBOC's upstream pricing, or ideal regulation that would ensure access by others to its local facilities on equivalent terms, the RBOC will retain both the ability and incentive to discriminate against competitors in the long-distance market. With only very limited possible exceptions, however, regulators' ability to regulate access to the RBOC's facilities will necessarily be imperfect, and long-distance competitors (and their customers) cannot expect to benefit from truly nondiscriminatory access to the RBOC's facilities until effective competition appears.

11. Public policy for at least the past 15 years has recognized that allowing a regulated, bottleneck monopolist into related markets carries substantial dangers. These concerns are firmly founded in the economics literature.[1] A regulated bottleneck monopolist has a strong financial incentive to enter into and control potentially competitive related markets in order to evade the constraints that regulators attempt to place on its profits and prices at the bottleneck level. It can block competition and gain control over those related markets it is allowed to enter simply by refusing rivals access to its bottleneck facilities. Where outright denial is not allowed,

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[1] See, e.g., J.A. Ordover and G. Saloner, "Predation, Monopolization and Antitrust," in The Handbook of Industrial Organization, Vol. 1, Ch. 9; R. Schmalensee and R. D. Willig eds. (North Holland) 1989.

it can be expected to attempt to provide access only on discriminatory terms. Where regulation constrains its profits in the core monopoly, an RBOC can expect that, by raising the input costs of its rivals, it could profitably increase its own price for the unregulated downstream service while suffering no offsetting loss in the constrained profits of the core monopoly. Where regulation directly constrains an RBOC's prices, but not its profits, incentives for discrimination remain pervasive because the profit gain downstream from discrimination will often outweigh any forgone profit in the core monopoly due to lost sales, and lost margins, due to discrimination against downstream rivals. Additionally, an RBOC may attempt to cross-subsidize its competitive activities with revenues from monopoly markets. This cost shifting is profitable to the extent that the RBOC is allowed to pass these costs through via higher prices to its local service customers.

C. An RBOC has strong incentives to discriminate against local telephone competitors.

12. Concerns over the RBOCs' ability and incentive to discourage local competition proceed from a different theoretical framework than the concerns described above over anticompetitive leveraging into adjacent markets. The RBOCs have continuing incentives to discriminate against local exchange competitors that are even more direct than their incentives to discriminate against rival long-distance suppliers. Indeed, there is substantial evidence that the incumbent local

exchange carriers ("ILECs") have frustrated competitive entry at every turn.[2] The RBOCs have incurred enormous sunk costs to build their local networks (albeit funded by their ratepayers). The modern economics literature on industrial organization recognizes the role that sunk costs play as barriers to entry.[3] When incumbents have sunk their costs, and entrants have not, incumbents are said to have a "first-mover" advantage.[4] First-mover advantages often turn out to be of strategic importance because the incumbent, having already sunk its costs, will have available a variety of tactics that are relatively costless to it but that can dramatically reduce the incentives of potential entrants to actually sink the costs necessary to enter. Moreover, since the value of monopoly profits will exceed the entrant's portion of industry profits, actions taken by the incumbent that appear to inflict equal costs or losses on both the entrant and incumbent will be highly profitable if, as a result, monopoly profits are preserved because entry is foreclosed or the scale of entry is reduced. This principle has been recognized by the Federal Communications

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[2]See, e.g., the Michigan Public Service Commission Staff's Request for Clarification, In the Matter of the Application of City Signal, Inc. for an order establishing and approving interconnection arrangements with Michigan Bell Telephone Company, Case No. U-10647 (July 26, 1995).

[3]The sunk costs associated with entry are the costs that cannot be recovered if the entry attempt is unsuccessful. Common examples are marketing costs (to the extent, as will usually be the case, that the "brand name capital" cannot be fully transferred to other markets), facilities costs (to the extent that full value of the equipment, less normal depreciation, cannot be recovered in a used equipment market), and any costs incurred to compensate customers for the costs they incur in switching suppliers. For a discussion of the relation between sunk costs and barriers or impediments, see Jean Tirole, *The Theory of Industrial Organization*, Chapter 8, The MIT Press (1989).

[4]First-mover advantages are not simply the product of being first. If sunk costs are not necessary for entry, no first-mover advantage exists.

Commission: "The economic principle at work . . . is that a monopolist stands to lose more profits than a duopolist has to gain; thus, the monopolist has a greater incentive to preempt than an entrant has to enter."[5]

13. Examples of potentially exclusionary tactics include:

a) Strategic use of long term contracts. Incumbents faced with potential entry have incentives to sign up customers for long term contracts and to stagger the terms of those contracts. Simply "locking in" customers with long term contracts pushes the threat of entry off into the future, since the size of the entrant's potential market is smaller. This, in turn, reduces the financial feasibility of entry. Staggering the contract lengths imposes a permanent cost penalty on entrants, since the potential market available to the entrant will be smaller in all periods.[6] Discounts that induce exclusive dealing (where customers deal with only one seller for a product) or contracts with high withdrawal penalties can have the same "lock-in" effect.[7]

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[5]Federal Communications Commission, Second Report and Order, Order on Reconsideration, and Fifth Notice of Proposed Rulemaking, CC Docket No. 92-297, Rulemaking to Amend Parts 1, 2, 21, and 25 of the Commission's Rules to Redesignate the 27.5-29.5 Ghz Band, to Reallocate the 29.5-30.0 Ghz Frequency Band, to Establish Rules and Policies for Local Multipoint Distribution Service and for Fixed Satellite Services at 76-77 (March 11, 1997).

[6]The long-distance industry now features a variety of calling and promotional plans. For businesses, concessions and promotional terms are often individually negotiated (even though the pricing plans themselves are offered on a nationwide basis). Thus simply by engaging in what is normal business practice in the long-distance business, an RBOC will be able to offer customer-specific discounts to local service customers most likely to patronize a new entrant. The discounts are pro-competitive in long distance, where facilities-based competition is well established. However, such discounts can discourage facilities-based entry for local service when employed by an incumbent who is just beginning to face competition.

[7]The consent decree between the U.S. Department of Justice and Microsoft requires that Microsoft remove from its contracts with computer manufacturers a particular discount structure that induced exclusive dealing. The decree also requires Microsoft to shorten the length of its contracts.

b) Poor service to new entrants. Providing poor service in provisioning network elements when switching a customer to a new local carrier raises the costs of entry, since the entrant will be forced to increase promotional and marketing expense to offset, as best it can, the adverse effects of the RBOC's poor performance on its own reputation.

c) Artificially raising the costs of switching between local carriers. Since the incumbent RBOC starts with all the local customers, policies that uniformly raise customer switching costs, such as setting artificially high nonrecurring charges for service ordering or line connection for unbundled network elements (UNEs), protect the incumbent's customer base and raise the costs of entry.[8]

d) Discriminatory access to customer information. For example, a local entrant who relies in part on UNEs must provide to the RBOC competitively sensitive information, such as the identity of customers who are considering switching to them from the RBOC. The RBOC then has incentives to target marketing resources to those customers to try to prevent the switch. The entrant has no such information when one of its customers is contemplating a switch back to the RBOC.[9]

e) Pricing of and access to UNEs. Access to unbundled network elements is key to many new entrants. Clearly, however, it is not in the RBOC's interest to assist its direct competitors. If unbundled elements are priced well above economic cost, or if the procedures for purchase of unbundled

[8]The ILECs' behavior in the intraLATA business provides a good analogy. When intraLATA competition has been allowed, several ILECs have instituted PIC freezes. A PIC freeze is a cessation of the customary practice whereby the LEC will change a customer's presubscribed interLATA (or intraLATA) carrier based on a request from that carrier authorized by the customer. When a freeze is in effect, a change in long-distance carrier cannot be implemented until the customer directly and personally provides authorization for the change to the ILEC. This raises the cost of customer switching, which is an advantage for an incumbent who begins with all or almost all the customers. PIC freezes can give the ILEC an advantage in competing for customers who prefer purchasing bundled local and long-distance service. The IXCs don't know which customers have signed up for the freezes, so they waste marketing costs reaching those customers. If the ILEC's long-distance affiliate knows which customers are more expensive to switch (because they have signed up for the freeze), then it is better able than its rivals to efficiently utilize its marketing resources.

[9]MCI has filed complaints against PacBell and SNET for precisely this type of behavior.

elements simply don't work very well, then entry barriers are higher than with cost-based pricing under a well-functioning set of purchase procedures. It is our understanding that the final pricing of UNEs is still not established in many states. Uncertainty over the pricing for major inputs can only inhibit entry.[10] In addition, it is also our understanding that there has only been very limited and unsatisfactory experience with how well the ordering, provisioning, and maintenance processes for UNEs under the arbitration agreements will work in practice. Slow, cumbersome, expensive, or unreliable processes can all impede or delay entry.

D. The "carrot" rationale for linking an RBOC's interLATA authority to the state of local competition.

14. Two local telephone markets are relevant to these proceedings: the downstream, retail market, where telecommunications services are sold to final customers, potentially by a large number of suppliers, and the upstream market for unbundled network elements ("UNEs"), where inputs are sold to providers of retail telecommunications services.

15. Because an RBOC's natural business incentive is to restrict and delay local entry, it makes sense to offer the RBOC both carrots and sticks depending on how local competition (which depends in large part on the RBOC's behavior) develops. One carrot is interLATA entry, which the RBOCs have coveted for some time. But since local competition depends on the degree to which an RBOC makes UNEs fully and generally available on reasonable terms, and the extent to which interconnections between local networks work in practice, it would be a

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[10] See Avinash Dixit and Robert Pindyck, *Investment Under Uncertainty*, Princeton University Press (1994).

mistake to give up the carrot too soon. Once an RBOC gets interLATA authority, its sole business incentive for cooperating in opening its network to competition will disappear. InterLATA authority should not be granted based on promises that the RBOC will have in place well-functioning methods for large-scale provision of UNEs at some time in the future. The state public utility commissions and the Federal Communications Commission cannot judge how well the UNE process is working until they actually see it in practice and have a chance to address the inevitable practical problems of implementation that will arise.

16. It is critical to note that an RBOC's incentives to discriminate (e.g., by placing artificial roadblocks to the smooth functioning of the unbundled element market) will increase significantly once competition develops at the retail level. For initial and small losses of retail business to the entrant, the RBOC's most profitable strategy will be to maintain its retail price and accept the loss of business, rather than cut prices more broadly. But as the amount of retail business that the entrants capture increases, at some point the RBOC will find it profitable to cut price to stem the loss of business. At that point the incentive to restrict (or increase the price of) the CLECs' purchases of unbundled network elements increases dramatically, since an increase in CLEC costs and hence prices now allows an RBOC to increase prices to its retail customers as well. It is thus important that the Commission recognize that RBOC incentives to frustrate local entry will be even higher in the future than they are today. This makes giving up the carrot too soon even more unwise.

E. Regulation will not be sufficient to prevent an RBOC from discriminating against its competitors

17. Faced with the undeniable incentives for anticompetitive behavior, advocates of RBOC entry into interLATA markets argue that modern regulation is more than capable of controlling anticompetitive behavior.[11] In short, they believe that regulation is capable of the intricate and detailed regulation that would be necessary to prevent a regulated firm from following the profit motive and engaging in the anticompetitive behavior that is so uniquely profitable for regulated monopolists. In contrast, we believe that competition is far better able than regulation to protect consumers and that delaying RBOC entry until local competition has developed will reduce the necessity for detailed regulation in the future. It is troubling that, after regulation has been largely removed from the long-distance business, RBOC entry into long-distance service is being considered while the RBOCs' regulated local bottleneck remains almost completely intact. Even the RBOCs' advocates recognize that the RBOCs' near-term entry requires the reintroduction of detailed regulation of their long-distance activities in order to control their anticompetitive incentives to leverage market power. AT&T has only recently been deregulated. The RBOCs' entry, even according to its advocates, reintroduces the ability to play the regulation game as an

[11]The RBOCs' witnesses also advance a straw man. They argue that an RBOC is unlikely to achieve market power or dominance in the interLATA business given regulatory constraints on anticompetitive behavior and the alleged implausibility of inducing the exit of any of the major incumbent long-distance carriers. But discriminatory behavior would be socially inefficient even if it did not result in a high enough long-distance market share to suggest an RBOC had obtained market power in interLATA service. Discrimination is a way of exercising local market power (by evading the regulators' limits on the prices or profits allowed in the local monopoly). This exercise of market power is privately profitable but socially harmful to long-distance consumers (by reducing output and raising price) even if the RBOC is unable to, in addition, obtain market power in long-distance service.

important determinant of competitive success in long distance. This would be truly unfortunate. Even remotely effective regulation would be very expensive. Moreover, there is strong reason to believe that regulation, as practiced, will not effectively prevent anticompetitive behavior.

18. Regulators face severe limitations in attempting to prevent RBOCs from acting on their anticompetitive incentives. For one thing, regulators are often unwilling or unable to impose penalties sufficient to dissuade an ILEC from refusing to obey the regulator's procompetitive orders in a timely fashion. The status quo then favors the ILEC in competition with other telephone companies. As long as the ILEC earns more money from disobeying a clear regulatory directive than it stands to lose from disobeying the directive, procompetitive orders will be ignored. The primary recent examples are the states, such as Minnesota and Michigan, where RBOCs have ignored Commission directives to implement one-plus dialing parity for intraLATA toll service. Rather than implement the directives subject to appeal, the RBOCs have sometimes simply refused to obey the orders while they appealed. Thus, at a minimum, the RBOCs can profitably delay implementation of Commission orders they do not like.

19. A minor variation on this theme entails taking the narrowest possible interpretation of one's legal obligations. Thus, for example, an RBOC might declare that a particular form of subloop unbundling is not technically feasible, even though it knows it is feasible. When caught, it may then obey regulators' orders to inform customer-competitors who ask that the unbundling is feasible. At that point, however, the customer-competitor still may not have procured the

necessary unbundled network elements due to further RBOC foot dragging. Rather, negotiations may then proceed to other issues, where the RBOC may take a similarly narrow view of its legal obligations to negotiate in good faith.[12]

20. Even where an active regulator might hope to prevent many affirmative misdeeds or overt acts of commission, regulators will find it almost impossible to enforce a nondiscrimination standard against omissions or failures to act. For example, it would be difficult to detect an RBOC's failure to treat unaffiliated and affiliated companies the same with respect to R&D projects, or failure to fund capital projects that benefit a long-distance rival at the expense of an RBOC's own long-distance affiliate.

21. Consider, for example, what would happen when an IXC needed the technical cooperation of an RBOC to introduce technical changes in long distance, either in the form of

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[12]This example is not hypothetical. For example, in negotiations with a new CLEC, BellSouth claimed that the particular form of subloop unbundling the carrier requested was not technically feasible. Several months later, the same CLEC was surprised to find that BellSouth's proposed SGAT in Georgia offered precisely the form of subloop unbundling that BellSouth had earlier declared infeasible on technical grounds. When the CLEC's witness complained about this apparent failure to negotiate in good faith, counsel for BellSouth proudly told the Georgia Commission that once it and two other state commissions had ordered BellSouth to stop telling CLECs that the requested unbundling was infeasible, they obeyed the orders and no longer told CLECs that the requested unbundling was technically infeasible. See cross-examination testimony of Julia Strow of Intermedia Communication Inc., Before the Georgia Public Service Commission, In the Matter of: Consideration of BellSouth Telecommunications, Inc. Services pursuant to Section 271 of the Telecommunications Act of 1996, Docket 6863-U, Transcript at 2252-56 (February 27, 1997). The incident is also discussed in Ms. Strow's direct testimony before the Georgia Public Service Commission filed Feb. 13, 1997, at pp. 18-20.

capital expenditures by the RBOC, or collaboration with the RBOC on technical interconnection issues. So long as the RBOC viewed a ban on its participation in interLATA toll as likely to be in place over the foreseeable future, it would have had an unambiguous financial incentive to cooperate with the IXC, since improved quality or lower prices for long-distance service would increase the demand for access and thereby benefit the RBOC. Once the RBOC integrates into long distance, however, its calculation would change. Any new competitive success by the IXC would come, in part, at the expense of the RBOC's long-distance unit, reducing or eliminating its financial incentives to cooperate with the IXC in facilitating efficient innovation.

22. Even in the absence of conflicting incentives, companies at successive stages are still sometimes unable to reach agreement on technical collaboration, perhaps because they have differing views on the technical merits of a project, or on costs to be borne by each party. Because technical collaboration often breaks down even when none of the players has anticompetitive incentives, it would often be impossible to determine with certainty in a given instance that an RBOC's decision not to cooperate with an IXC was due to anticompetitive motivation rather than to an ordinary commercial disagreement. Such uncertainty is particularly important because it could prevent the regulator from imposing tough penalties on the RBOC if and when the regulator does decide that the company probably has behaved anticompetitively. In the terminology of law and economics, a high probability of a "false positive" (behavior is deemed anticompetitive when in fact it is not) means that behavior that is not always detected and punished cannot be efficiently deterred using large penalties. Significantly greater regulatory

oversight and expenditure is required in such cases since, absent penalties, anticompetitive behavior can only be deterred by reducing the probability of a "false negative" (an incorrect finding of no anticompetitive behavior) to a minimal level. Translated into common terminology, this means that if you do not severely punish bad behavior, you have to catch almost every violation.

23. Regulation of access and interconnection will be especially prone to failure when technology is changing rapidly. Even if reasonable requirements were established for the old technology, those regulations would soon become obsolete, along with that technology. Consumers of access services and regulators must then examine anew whether the restrictions with its rivals are reasonable or not. As we discuss below, this makes the regulatory progress prone to reversibility; i.e., regulations that worked well yesterday won't work well tomorrow.

24. Perhaps the best historical examples of the effects of information limitation on regulators are from the equipment side of the AT&T case. AT&T committed to various regulators that it would not discriminate against independent equipment suppliers. However, the Bell System found a whole series of seemingly plausible excuses for purchasing from Western Electric. Regulatory oversight of the Bell System's procurement practices was ineffective. Antitrust action, with extensive after-the-fact discovery, was necessary to prove that there were in fact abuses. But only divestiture — with the associated rapid fall in the share of the RBOCs'

purchases from Western Electric — could really establish the existence and strength of the bias toward internal purchase in the integrated AT&T.

F. Examples of discrimination by LECs against their competitors

25. There are many examples of ILECs behaving anticompetitively in markets that depend on access to their bottleneck facilities.

a) In Michigan, Ameritech has repeatedly challenged (and sought to overturn or delay) the PUC's orders to provide intraLATA one-plus presubscription. Ameritech's refusal to accommodate market-opening regulations has seriously slowed the development of intraLATA toll competition.

b) Ameritech initiated "PIC freezes" in three of its five states, just when those intraLATA markets were opened to presubscription.[13] Moreover, the PIC-freeze solicitations were found, at least in Illinois and Ohio, to be anticompetitive.

c) The growth of local competition in Grand Rapids, Michigan was blunted by Ameritech's interconnection tariffs, which were rejected five times by the Michigan Public Utilities Commission.[14] The growth of the local entrant, US Signal (now Brooks Fiber), fell far short of plan, and its legal fees in the first year of operation far exceeded its revenues.[15]

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[13]The PIC freezes raise the costs of changing carriers which, given Ameritech's large share of intraLATA traffic, inflicts far greater costs on its rivals than on itself.

[14]In Georgia, ACSI raised similar objections to BellSouth's behavior. It filed a complaint with the Commission that BellSouth failed to install requested services needed for local service in a timely fashion.

[15] Douglas Bernheim and Robert Willig, The Scope of Competition in Telecommunications, AEI Studies in Telecommunications Deregulation, Oct. 1996, at pp. 85-86.

d) Bell Atlantic delayed introduction of ISDN capability for PBX trunks until over a year after it had introduced the ISDN feature for its competing CENTREX service.[16]

e) In cellular service, Bell Atlantic resisted testing new service implementation with McCaw until the new features had been tested and implemented for its own cellular operation in Pittsburgh.[17]

f) BellSouth strategically altered the timing of unbundled network features in an effort to favor its own MemoryCall service.[18]

g) The Kentucky and Florida Public Service Commissions found that BellSouth had engaged in anticompetitive business office practices to disadvantage its intraLATA rivals. Such practices are quite difficult to monitor.

h) SNET has already achieved significant market shares in interLATA long distance (various press reports attribute to SNET 25-34% of customers and a much smaller percentage of revenues). That share cannot be readily explained by pricing since SNET's prices are not lower than the calling plans other long-distance carriers are offering. SNET's current share itself may be the result of discrimination. SNET terminated its billing arrangement with AT&T after its own interLATA entry and began advertising that customers could now receive one bill through SNET but not AT&T.[19] Absent incentives to discriminate against (or to withhold cooperation from) rival IXCs, SNET's decision to terminate its billing arrangement for AT&T is puzzling. Although AT&T had plans to bill on its own in the future, it would have been profitable for SNET, absent an incentive to discriminate, to continue to bill for AT&T until AT&T was ready to make the switch. Instead SNET abandoned the profits it was earning on billing for AT&T. Why? Ending the billing arrangements with AT&T must have resulted in an

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[16] Id., Chap. 4 at 95.

[17] Id., Chap. 4 at 94-95.

[18] Id., Chap. 4, at 97, citing In the Matter of the Commission's Investigation Into Southern Bell Telephone and Telegraph Company's Provision of MemoryCall Service, Order of the Georgia Public Service Commission, docket No. 4000-U (May 21, 1991).

[19] SNET's market share has come predominantly from AT&T. SNET has continued to bill for other long-distance carriers, so the other IXCs were able to continue "one-bill" service to their customers after SNET's entry.

increase in profits in other markets that more than offset the profits lost from ending the billing arrangement.

i) For almost ten years US WEST successfully resisted orders from the Minnesota regulator to provide one-plus intraLATA dialing.

26. It is especially important to note that all of these actions were done in the face of regulation by state commissions. Moreover, to the extent these actions were caught by state commissions, it was only after the fact -- in many cases, well after the competitive harm had already been done. The RBOCs retained the benefits of the past anticompetitive behavior whenever, as is usually the case, the only penalty for being caught was an order to cease the offending behavior.

III. ACCESS PRICING

27. The Federal Communications Commission's decision on access price reform has important implications for the proper timing of RBOC long distance entry. The Commission decided against prescriptively reducing access prices to economic cost. The access revenues of the ILECs will be reduced, but not by anything close to the amount necessary for the revenues collected to be commensurate with the economic costs of access. The Commission also decided to restructure access prices so that non-traffic-sensitive costs will gradually be recovered through fixed charges rather than through per-minute charges. In particular, certain traffic-sensitive costs that were formerly recovered through per minute charges to the IXCs will gradually be recovered through a monthly, per-customer charge paid by the IXCs. This restructuring will gradually

reduce the competitive pricing advantage the RBOCs will have in long distance service. However, because the restructuring occurs only gradually, the near-term entry by an RBOC into in-region, interLATA service will give it a competitive pricing advantage for long-distance service (and for bundled services that include long distance) unrelated to the cost efficiency of its long-distance operations. The RBOCs' pricing advantage is discussed in detail below.

28. The restructuring of access payments by the IXCs is inefficient for another reason.[20] The new monthly fixed charge paid by IXCs, the primary interexchange carrier charge ("PICC"), will have perverse consequences. The PICC will raise the cost for IXCs of serving low-volume

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[20]The Commission recognizes that for end-users, efficient pricing requires that non-traffic sensitive (fixed) costs should not be recovered through traffic-sensitive prices. As an example, a two-part price schedule, with a per-unit (traffic-sensitive) payment to recover variable (traffic-sensitive) costs and fixed payment to cover all other costs, is the efficient way to price to end-users. However, the same principle does not apply with respect to products sold to intermediate buyers such as IXCs, who buy access from LECs and then sell their product to final consumers. Two-part pricing of inputs sold to intermediaries is often not efficient. The fixed or lump-sum payment raises the fixed costs of downstream companies and can reduce downstream output by reducing the number of viable competitors downstream. (See Janusz Ordover and John Panzar, "On the Nonlinear Pricing of Inputs," *International Economic Review*, October 1982.) Indeed, two-part pricing of inputs, such as the FCC is proposing for primary interexchange carrier charges ("PICCs") paid by IXCs, is often not only inefficient, it can be anticompetitive and exclusionary as well. (See Kenneth C. Baseman, Frederick R. Warren-Boulton and Glenn A. Woroch, "Microsoft plays hardball: the use of exclusionary pricing and technical incompatibility to maintain monopoly power in markets for operating system software," *Antitrust Bulletin*, Summer 1995.)

In this case, the exit induced at the downstream level by the lump-sum payment is not the exit of the entire firm but rather the exit of downstream firms from particular market segments (e.g., low-volume customers). Where direct or deliberate exit is not politically feasible (that is, an IXC may not be allowed to discontinue service to customers who presubscribe to it, but on whom it loses money), the PICC still reduces the incentives of IXCs to compete aggressively to serve the unprofitable segment. If the IXCs are allowed to flow through directly the per-line charges they pay as per-line charges to consumers, then the effect on universal service is the same as if the per-line charge were placed directly on consumers in the first place.

customers. Ironically, the Commission's stated rationale for placing the new fixed charges on the IXCs rather than the end-users was a fear that too many users may discontinue phone service if the fixed monthly cost for service increased. Instead, the Commission decided to place the fixed monthly charge on the IXCs. But this merely increases the customer-specific fixed costs for the IXCs to reach these customers. When low-volume customers become less profitable to serve, the financial incentive for the IXCs to compete to serve them is reduced. Indeed, because very low-volume customers are now unprofitable for IXCs given the current level of customer-specific fixed costs, the PICC will only exacerbate the problem. It is indeed ironic that the FCC is raising the costs for the IXCs to serve low-volume customers, while the RBOCs are arguing that they should be allowed into long-distance service in order to correct a perceived lack of competition for the patronage of low-volume customers. To the extent the RBOCs' allegations that more competition is needed for low-volume customers have any merit at all, the last thing the Commission should do is increase the costs the IXCs must bear to serve these customers.

A. Access prices should be reduced to economic cost before an RBOC is allowed to provide in-region, interLATA service.

29. Reducing access prices to economic cost is highly desirable, especially to the extent that widespread, effective local competition is not in place prior to the time when an RBOC is permitted to provide in-region, interLATA service. First, reducing prices to cost is economically efficient. With the advent of local competition, access reform provides proper cost signals to the